

The Week

Gary Thayer, Chief Macro Strategist

An eight-legged table

The recovery from the 2008-09 recession has been slow. Consequently, many investors are worried that the U.S. economy will fall back into another recession. We, however, continue to believe that the probability of a second recession or double dip in the economy is only about 20%. That's because the recovery in corporate profits is very broad, making the economy more resilient than the headline economic news suggests.

When people look at the economy, they often judge its strength by its speed. After all, this is what they hear in the media. A slow recovery is assumed to be weak or tenuous. If anything goes wrong, they believe that the economy will fall back into recession. However, in order to judge the true strength or resiliency of the recovery, investors should look at the breadth of the recovery as well as its speed. A slow recovery can be resilient as long as it is broad. For example, if a table has eight legs, you can kick one of the legs out from under the table and the table will still stand. Alternatively, a narrow economic recovery would be much more tenuous, like a three-legged table. If you kick one of the legs out from under a three-legged table, the table will fall. The good news is the current economic recovery is more like an eight-legged table than a three-legged table.

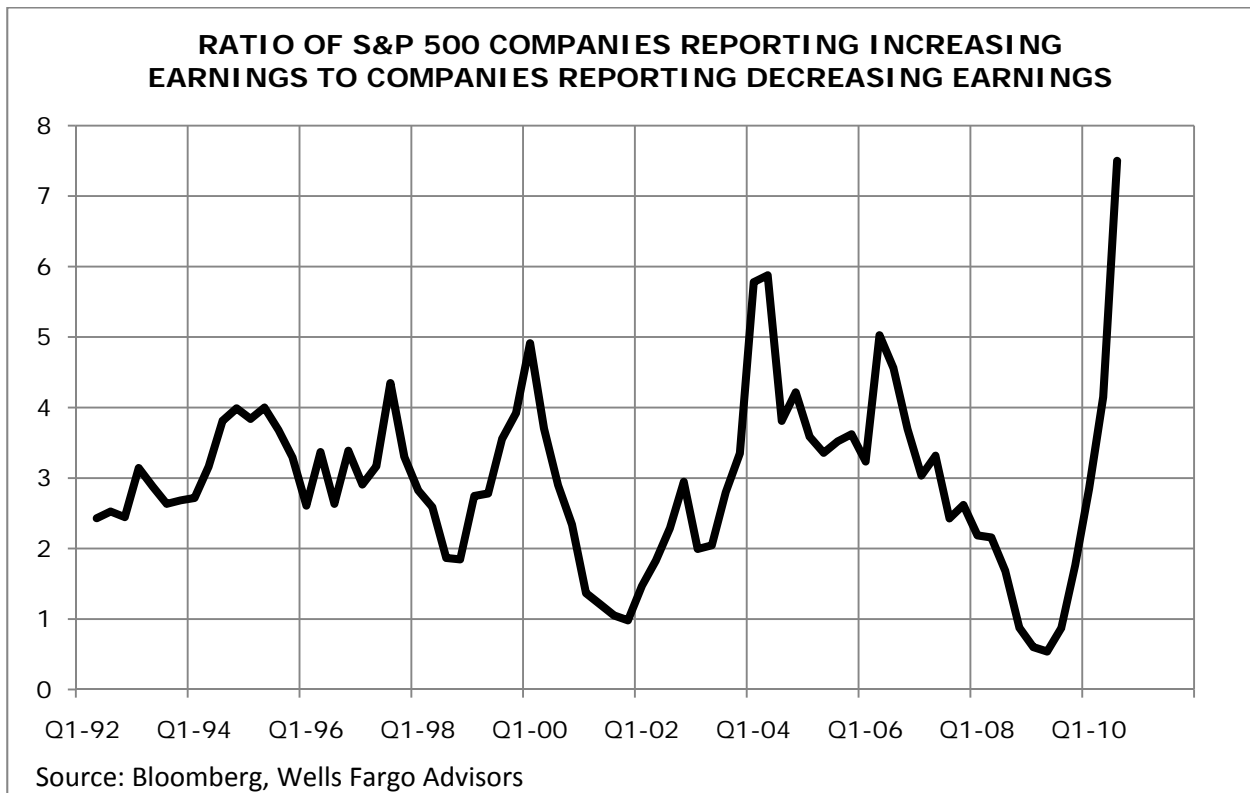
We have been saying for quite some time that we are long-term positive on the economy and the stock market, but near-term cautious. We recognize that the economy still has many problems to work through. As a result, the stock market is likely to remain volatile. In particular, we are concerned that the next couple of months could be a period of weakness that will test the long-term resiliency of the economy and the market. We believe the stock market has already discounted several positive developments about the election and Fed policy and could be subject to profit taking or disappointment during the next few months, if events are not better than already elevated expectations.

The U.S. economy is always dealing with problems. At any given point in time, something is going wrong somewhere. This is normal. However, the impact of something going wrong depends on the

resiliency of the economy when those bad events occur. If the economy is weak when something bad happens, the bad event aggravates an already bad situation and the economy can suffer greatly. This is what happened in 2007 and 2008 when oil prices spiked upward and the housing market dropped at the same time. The economy was already in a weakened state in 2007, and these negative events caused the economy to fall into recession.

Fortunately, this is not the case today. If the economy is healthy and resilient, something bad can happen and the economy may not suffer significant damage. Once again, that's because a broad-based recovery is like the eight-legged table. It can take a hit in one or two sectors and still continue to expand. Consequently, it is important to know what events are taking place that could hurt the economy but also look at the environment in which those events are occurring.

This week's chart looks at the breadth of corporate profit growth of the companies that make up the S&P 500. Our equity strategy team closely monitors this relationship and recently reported that the number of companies reporting year-over-year increases in corporate profits far exceeds the number of companies reporting year-over-year decreases in profits. With almost one-third of the S&P 500 companies reporting third quarter results, the ratio of up-to-down earnings reports is running 7.5 to 1.0. This means that more than seven times as many companies are reporting increasing profits as are reporting decreasing profits. This is the broadest increase in profits in at least 18 years. It is also a very encouraging sign that improvement in the economy is not isolated in just a few companies or industries.



More important, the breadth of the increase in profits is far different today than it was just prior to the 2008-09 recession. In the year before the last recession, fewer and fewer companies were reporting increases in corporate profits. This meant that the economy was like a three-legged table and was not very resilient. When oil prices spiked upward and the housing market dropped, the economy had very few legs to stand on. We would be more concerned about a double-dip recession, if corporate profits growth was narrow and deteriorating as it was before the last recession, rather than broad and improving as it is now.

Corporate profit growth is not the only area that is experiencing a broad recovery. Job growth may be slow, but it is improving in many sectors, not just a few. In fact, the breadth of the recovery in nonfarm payrolls is better in the current economic recovery than it was at this point in the recoveries from the previous two recessions.

The U.S. economy is experiencing a slow recovery but we believe it may be more resilient than the negative headlines suggest. If we are correct and the U.S. economy is unlikely to fall back into recession, why are Federal Reserve policymakers

talking about providing more stimulus to the economy? This is because the Fed is charged with creating both full employment and stable prices. Therefore, Fed officials appear to favor a faster recovery that will increase jobs and reduce unemployment, rather than a slow and steady recovery that does not bring down the unemployment rate very fast. However, the Fed needs to be careful that it does not provide too much stimulus that would be difficult to reverse when necessary.

In the meantime, we recognize that the stock market is still vulnerable to disappointment or profit taking in the near future. In last week's report, we said that it will be important to watch China. Within a couple of days, China raised interest rates creating a brief drop in global markets. We also said last week that the next couple of months could be a time of testing for the economy and the markets. Nevertheless, we remain long-term positive, in part because the recovery in corporate profits is widespread and not isolated to a few companies or industries. Therefore, the economy is probably resilient and able to deal with some setbacks along the current bumpy road to recovery.

Important Information, Risk Factors and Disclaimers:

- Past performance is not a guarantee of future results.
- An index is not managed and is unavailable for direct investment.
- Diversification does not guarantee a profit or protect against loss.
- Investing in foreign securities presents certain unique risks not associated with domestic investments, such as currency fluctuation and political and economic changes. This may result in greater price volatility.

Investment and Insurance Products: ▶NOT FDIC Insured ▶NO Bank Guarantee ▶MAY Lose Value

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. The Standard & Poor's indexes are unmanaged, weighted indexes of stocks providing a broad indicator of price movement. Individual investors cannot directly purchase an index.

Wells Fargo Advisors is the trade name used by two separate registered broker-dealers: Wells Fargo Advisors, LLC, and Wells Fargo Advisors Financial Network, LLC, Members SIPC, non-bank affiliates of Wells Fargo & Company.

H.D. Vest Investment ServicesSM, Member SIPC, a non-bank subsidiary of Wells Fargo & Company, and an affiliate of Wells Fargo Advisors.